CONSIDERATIONS ON THE ISSUANCE OF MUNICIPAL BONDS IN ROMANIA[1]

BUNESCU Liliana

Abstract:

The global financial crisis raised the price of the access to bank loans, a viable solution for financing is represented by issuing municipal bonds. This paper presents the current situation of municipal bons issues in Romania focusing on destination, on costs, on loans' guarantees and their impact on indebtedness of local government. Local municipal bond market in Romania has a relatively short history, tailored after 2001, knowing that a considerable advance in recent years. The most common reasons for which public authorities are calling for loans are: either in need of cash or in need to balance the budget.

Keywords: *municipal bonds, interest rate, maturity, grace period*

Bonds play a key role in daily economic life of Europe and of the whole world. Calling the financial resources obtained from state or regional ones it is a universally valid practice applied by all countries. It can be note the large share of governamental bonds in total bonds issued in a country, municipal bond having a relatively low weight. The phenomenon of globalization and increasing number of European bonds' markets had created a range of opportunities for investors. Although the global bond market has been dominated traditionally by the U.S., the U.S. bond market currently attracts less than half the size of the market, about 44%. In Europe, 60% of the bond market is held by government bonds (http://www.investinginbondseurope.org/Pages/LearnAboutBonds.aspx?folder_id=464)

Currently, the international bond market size amounts to about 45 trillion dollars, with an optimistic outlook. U.S., Britain and the eurozone countries are those that dominate this market. U.S. bond market is the best in the world, accounting for more than half the world market (http://finance.mapsofworld.com/bond-market/outlook.html). Spectacular growth of bond market recorded in Asian countries like India and China.

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Local budget revenues consist of own revenues (taxes, contributions and other payments, other income and allowances deducted from the income tax), amounts deducted from certain income of state budget, state budget subsidies and other budgets, donations and sponsorships (Article 5, para. 1 of Law no. 273/2006 on local public finances). Territorial-administrative units are entitled to sufficient financial resources, the local government authorities can use in their duties. Local government authorities have the power to establish rates for local taxes. According to Art. 20 of the Law on local public finance, administrative-territorial units have powers to direct contracting of domestic and foreign loans, on a short, medium and long term. They must repay them at liabilities' maturity. The loccal public administration have the right to guarantee iternal or foreign loans. Annual surplus of the local budget will be used to repay any outstanding loans, interest payments, commissions, charges and other related costs. Administrative-territorial units may benefit from external loans contracted or guaranteed.

Lack of vision and understanding in economics has made in previous years of the crisis that funding needs to be accomplished by municipalities through repayable loans, neglecting other forms of financing such as public-private partnership or absorption of EU or government funds. It is currently in accession the issuance of municipal bonds to attract financial resources. Both investors and mayors of municipalities have a number of advantages from bonds' issues: both parties avoid financial intermediation of banks. Investors receive interest greater than on deposits and municipalities are borrowing cheaper than if they apply to a bank loan. Municipal bonds are treated theoretically, financial instruments with a slightly higher risk than bonds, but at least until now, the bond market did not experience incidents of payment. Capital market allows local councils to obtain financing better tailored to investments, although issueing costs are not insignificant and they are involving many formalities. The 33 currently listed bonds' issues in Romania (1.04.2010) are almost 185 million euros. On Romanian market already exists a number of local councils with a clear funding strategy, calling it a series of successive issues of municipal bonds.

Romania's economy and capital markets have provided the conditions of new issuers that offer to investors some viable long term development businesses and contribute to overall economic growth. Such movements were observed in the market since 2001 when they were launched and the first public offerings of municipal bonds which were subsequently listed on the Stock Exchange and have had an upward trend for the number, amount of repayment schedules and deadlines. Trading in bonds on the capital market in Romania should be characterized by transparency, assuming competitive market mechanisms, early publication of plans for contracting public loans, bringing clear to the investors of the terms and conditions of new issues so that they are well understood .

For bankers, the municipalities are interesting for several reasons. First, it is large amount of funding that they need - hundreds of millions of euros in each case. Secondly, public authorities have a reasonable risk share, much lower than at retail or corporate. And last but not least, there is a sufficiently large number of municipalities that are not in competition, as in corporations. The largest municipal bond issues so far are the City (180 million lei) and Bacau (122.45 million lei). Most seasoned municipal bonds have been issued so far is 20 years. 15 local authorities have already called more than a bond issue, moreover, eight of them are already in more than two bond issues, and cities such as Timisoara, Bacau Alba or more than five successive issues municipal bonds.

Box No. 1 market for municipal bonds in figures 04.01.2010

Total municipal bond issue in Romania	65
Number of municipal bond issues listed on BVB	33
The total value of listed debt securities	758,15 mil. lei
The largest municipal bond issue	100 mil. lei Ia□i 2008-2028
The smallest issue municipal bonds	Listed - 1,5 mil. Teiu□ Unlisted – 0,5 mil. Aiud and Predeal
Most maturity of a bond issue listed on stock exchange	20 years Alba – Iulia, Bistrita, Hunedoara, Ia□i, Oră□tie, Predeal, Slobozia, Tg. Mure□, Timi□oara etc.
The lowest maturity of bond issues listed on the stock exchange	Listed – 6 years Oradea, Timi□oara Unelisted – 1 year Cluj-Napoca, Slobozia
The most indebted local authority	Timi□oara 170 mil. lei, Bacău 110 mil. lei
Number of local authorities who made successive issues of municipal bonds	15 cities (Timi□oara 7, Alba Iulia 6, Bacău 5, Tg. Mure□ 4, Cluj Napoca 3, Sebe□ 2, Deva 2, Bistrita 3, Aiud 2, Hunedoara 3, Oradea 2, Predeal 3, Năvodari 2, Lugoj 2, Slobozia 2)
Highest coupon rate	Listed – variable + 3% Oradea, fixă 8,25% Timi□oara Unlisted – variable + 3% Predeal, flat 14% Arad
Lowest coupon rate	Listed – variable + 0,1% Timi□oara Unlisted – variable + 0,98% Oradea
The largest denomination of municipal bonds	150 lei Oradea, Aiud
The smallest denomination of a municipal bond	10 lei Predeal, Slobozia, Zalău, Cluj Napoca

Source: Processed data from the Bucharest Stock Exchange statistics (www.bvb.ro) and primary offering prospectuses of municipal bonds available electronically on the website www.kmarket.ro

Not all municipalities have been issueing successful debentures. For example, Botosani city recorded first municipal bond market failure, it failed to sell only 10% of the issue of bonds amounting to 10 million lei. The program was launched in January 29, 2010 and the deadline by which it could subscribe was extended three times, the last being on March 3, 2010. For considering the municipal bonds offer as successfully completed the degree of subscribtion must exceed 50%. One of the reasons for this failure was competition with governmental bonds, which are preferred by banks. The local authority planned to sell 100,000 bonds, each with a nominal value of 100 lei. Securities were scheduled a maturity of 17 years and a variable interest rate, calculated according to average interest ROBOR ROBID and six months plus 2.3% (BT Securities, Prospectus for public offerings of bonds issued by the city of Botosani, CNVM Decision no. 79/19.01.2010). Botosani city intended to attract co-investment projects supported by 75% from funds and assistance. For Botosani bonds offer no bank subscribed to the funding bid, BT Securities as a broker attempted to obtain money only from investors in the market. Whether successful or not an issue is accompanied by a number of significant costs, for Botosani city reached the equivalent of 5,600 euros. So Euro 5000 has been a fixed fee of BT Securities intermediary and promote a cost about 600 euros in two national newspapers.

Currently there are 33 marketable municipal bonds issues on Bucharest Stock Exchange. Thus 19 municipalities, cities or municipalities have resorted to this method of financing for their local budgets, most are due after 2020. Municipal bond issues were made at a nominal value of 100 lei per title and shall bear a variable coupon based on the average of ROBID (Romanian Interbank Bid Rate - the benchmark interest rate calculated as the arithmetic average of interest rates quoted by the 10 participants in fixing for deposits. Can be calculated from maturities of 1 day, 1 week, 1, 3, 6, 9, 12 months) and ROBOR (Romanian Interbank Offer Rate - the benchmark interest rate calculated as the arithmetic average of interest rates quoted by the 10 participants in fixing for credits. Can be calculated from maturities of 1 day, 1 week, 1, 3, 6, 9, 12 months) to 3 months or 6 months, plus a percentage of interest, it ranging from 0.1% in Timisoara and 3% for Oradea. Timisoara is the only local government which in 2005 issued municipal bonds with fixed interest rate of 8.25%. Nine administrative-territorial units in the period 2004-2010 issued securities with maturities over 20 years, namely Alba Iulia, Bistrita, Hunedoara, Iasi, Orastie Predeal, Slobozia, Tg. Mures, Timisoara. The reasons for the slower development of fixed income securities market in Romania may be related to the lack of bond trading companies (until 2008) and to the low number of issues. Issuance of municipal bonds may be seen as another step towards local financial independence, supported by local decentralization. This kind of loans are redeemable only from locally collected resources.

Until now most issuers that have used this way for their financing needs are local councils of various cities from Romania which started development programs. Mostly local projects were financed by bonds gave a favorable note of the local budgets. The first municipal bond issuers were Predeal and Mangalia cities and their destination was, in both cases, to finance tourist projects. Since then, municipal bonds have funded infrastructure projects, housing construction or upgrading, gyms or schools or even municipalities have provided co-financing required to participate in European projects.

Table 1 Destination of funds collected by issuing municipal bonds

Destination	City
Public spaces (parks, fountains, market management, cemetery management), infrastructure (sewer, asphalt streets, building parks, pedestrian facilities, water network, building passages, extending the natural gas distribution network), social canteens repair, building passages, housing construction , public lighting, waste management, cleaning station, sewer rehabilitation, land acquisition for housing	Băile Herculane, Ia□i, Oravita, Aninoasa, Slobozia, Alba Iulia, Timi□oara, Năvodari, Foc□ani, Bistrita, Eforie, Aiud, Oră□tie, Siret, Oradea, Cluj Napoca, Câmpulung Muscel, Zalău, Giurgiu, Deva, Sebe□, Teiu□, Târgu Mure□
Loan repayment	Alba Iulia, Bistrita
Theater, swimming pool, hospital construction, zoo, home education, culture development house, churches, schools	Bacău, Timi□oara, Năvodari, Cluj Napoca, Medgidia, Mangalia, Lugoj
County roads, local transport, road bridges, traffic lights, tram lines	Hunedoara, Foc□ani, Arad, Lugoj
Tourism	Predeal, Mangalia, Deva

Source: Data processed from the bonds' primary public offering prospectuses

In taking a decision about appliyng to external flows of public resources is very essential a restriction, namely, the cost of getting them. For an effective public activity the size of this cost must be minimized, the cost of financing should be expected. We believe that the authorities should build a proper strategy and tactical procedures for carrying it out. It is desirable to publish a national strategy in this area, focusing on relationship-destination cost of financing. Cost of financing is the rate of return required by lenders, namely the effort that the state must made to "supply" of money.

Financing costs by issuing municipal bonds differ according to supply primary intermediary, the issuer and the bond loan, consisting of:

1. Brokerage cost includes, in most cases, a fixed fee, expressed in lei, and a variable commission, as percentage applied either broadcast or subscription value or to the amounts paid by the issuer as interest and principal repaid. For example, for municipal bonds AIU05 (Aiud) intermediation cost was 1.6% of the issue value, for ALB25A (Alba) the cost of intermediation was of 5,000 lei and 0.3582% of the emission value, for PRD03 (Predeal) it was 2.5% of the amount subscribed and 0.3% of the issue value, for Teiuş bonds was 12.750 lei. If there are more than one intermediar, these fees are split between syndicate members. For example for Giurgiu municipal bonds the brokerage fee was 1.5% of the total amount obtained by selling bonds, but not more than 50 million, each divided in proportion to participation in mediation supply, ie 90% was for Rombell Securities SA, acting as syndicate manager, and 10% was for BCR Securities SA.

2. Sales group commission are expressed as percentage applied when the authorities are cashing the value of bonds from investors and as a commission when the authorities pay the interest to investors. Another way of calculating this fee was applied by Deva municipality for its issues, namely BCR Securities intermediate, namely 0.6% for every transaction for collection but not less than 1 RON lei per transaction and a fee of 0 , 5% for every cash transaction lifting.

3. National Securities Commission authorization fee

4. Tax filing service to issuers within the Department of NSC.

5. Advertising expenses in accordance with the law on capital market in two national publications.

6. Multiplication and distribution expenses of the offer for public.

7. Bucharest Stock Exchange expenditure: processing fees, listing and maintaining to the exchange stock. In 2009 issuers were exempt from processing fees and stock exchange listing fee. Processing fee is a fee charged by BSE for documentation analysis to trading admission. (1200 RON). Charge admission to trading is a charge payable in advance by issuer corresponding to a period of 12 months, a period which runs from the start of trading. It is also called the listing fee (0.001 % of the nominal value of bonds). Keeping the transaction fee is a yearly fee, payable in advance by issuer to maintain the bond son the market corresponding to a period of 12 months (0.05% of the nominal value remaining to be repaid). For listining municipal bonds a public authority should issue municipal bonds exceeding the nominal value of EUR 200,000.

However to all costs from above it adds the cost of interest due and paid by local authorities. Deciding to issue ore not municiapl bonds depends on the low cost of variable coupon rate and on a maturity longer than those offered by commercial banks on loans. In terms of investor, the most important competitor of municipal bonds are governmenteal bonds. The main feature that makes government securities attractive to investors is the fixed interest which they provide to maturity. This means that while the initial rate offered by municipal bonds will be higher than bonds issued by gouvernment during the same period, after some interest adjustments 1-2 (3-6 months). It will fall below the sovereign interest rate (the zero one). Using the average between ROBOR and ROBID as reference rate is questionable, it have a limited relevance for borrowing market. First, these rates refer to a period much shorter than the bond maturity. Secondly, the rates charged by commercial banks for loans are based on their financing costs, they are similar but not identical with ROBOR. ROBID has limited relevance for deposits and no relevance to investors, their alternative investments are government securities and no bank deposits.

In conclusion, the approach now used for calculating the interest for municipal bonds is that an investor receives a lower interest rate than investment in government securities. In other words, the municipalities are financed with lower cost than the central state budget where investment risk is considered to be zero. The third important reason that makes investors becoming less interested in municipal bonds is the lack of credibility in the secondary market. Although they are listed, because small amounts are traded and the investor base is limited, we have to wait months to see a secondary market transaction. Secondary market price is another factor having a negative impact on liquidity. Most of these bonds not only have a variable rate, but the principal is amortized over the maturity period. This explain the detention of investors to participate in transactions.

For Romanian economy the main problem in calculating cost of debt greater than one year is linked to a real anticipation of interest. Cost depends on interest rate, on maturity and on the volume of issued bonds. The selection of sources for fundsof funding is quite complex because besides the cost criterion there are some restrictions on local budgetary deficit and indebtedness.

Loans of local public administratioms may be secured by them through their own income. Any guarantee by revenues is valid. Income that is under warranty and which are received to the local budget will be subject to guarantee agreement. This guarantee agreement will apply with priority over any claims of third parties to the local authority, whether such third parties are aware or not knowing the guarantee agreement.

The approval of a loan by a local government is not a form of guarantee of that loan. Local governments ensure interest payments and repayment at maturity in terms of law and in accordance with a "guarantee agreement" signed by the authorized administrative-territorial unit. Local authorities ensure the full payment of debendure loan and interest by all their fiscal power, by all tax revenues, by their own income. Guarantee Agreement shall apply with priority over any claims of third parties, whether such third parties are aware or not aware of the guarantee agreement. The execution of guarantee agreement will be continued by the successors officer of the mayor that have contracted the bond loan and it is enforceable.

Municipalities are forced to repay the loan and to pay interest and fees for this debt without the government to have any liability and its credibility or ability can not be used to repay local debt. IMF recommended to Romania that prior approval procedure of loans by the government should be inhabited, gradually, with a control procedure made in local budget monitoring process.

Local public administrations are banned from lending or guaranteeing any loan, if the total debt (outstanding loans or guaranteed ones, interest and related charges, including the loan to be contracted and / or guaranteed in that year) exceeds 30% of their total income, consisting in taxes, contributions and other payments, other income and allowances deducted from income tax from the state budget (Article 63 para. 4 of Law no. 273/2006 on local public finances). Local government debt is a general obligation to be reimbursed under some agreements from own revenues of local authorities. Local debt instruments are securities, loans from commercial banks or other credit institutions, credit provider, financial leasing, local warranty. Securities issueing may be made directly by local government authorities or through agents or other specialized institutions.

In 2009 two of the municipalities that have ongoing municipal bond issues (Baile Herculane and Oravita) were recorded delays in debenture interest payments on loans contracted - the first incident of this type on capital market in Romania. City of Baile Herculane was in delay with payment of interest on bonds issued because the new mayor of the town do not accept one of the investment projects of the former mayor (Adrian Mosoianu, How safe are municipal bonds?, Financial Newspaper, 20/11/2009). They were launched in 2006 in a total volume of 3.15 million lei with maturity in 2020 and variable yield, representing the average of six-month interbank interest rate plus a premium of 1.5% (www.kmarket.ro/emisiuni/afisare_obligatiune.php?nume=Baile Herculane&id=243).

A similar case occurred in octomber 2009, when Oravita local authorities have delayed interest payments for municipal bonds issues. The accounts of mayor hall have been blocked due to an unpaid debt of 170,000 lei to Enel company. Oravita bonds worth 6 million lei, were issued in 2008, for 20 years, with interest equal to the arithmetic average of interbank deposits and credits interest on six months plus 1.3% (http://www.kmarket.ro/emisiuni/prospecte/Pr_Of_Pub_oravita1.pdf) . The two cases of late payments of interest related to municipal bonds are first of this kind in the history of Romanian capital market after 1990.

Therefore can not ask a local authority insolvency eventually detect it, but may be required under Art. 123 of Law 215/2001, enforcement of the debt, by tracking which is public property of that authority, by blocking current accounts, by selling movable property, and if it do not cover the debt by selling the unmovable property. The degree of transparency of municipal bond issuers listed on the Bucharest Stock Exchange on important events that can have a very lower impact on their financial status. Mostly bonds issuing municipalities report information to the stock exchange on calculation and payments of interest and nothing else. Regulation no. 1 / 2006 of the National Securities Commission (NSC) require for municipalities only limited transparency obligations regarding the issueing prospects, not for further stock market listining.

Regarding the negative aspects on municipal bonds issues, primarily it is need to emphasize that there is not a history of determinating the risk of late payments considering the loans or interests. Municipal bonds ranking is quite speculative, there is not a reliable benchmark for assessing the spreads. Secondly, an issue of municipal bonds increase the indebtedness rate and the local debt. It also notes the lack of a secondary market for government securities and municipal ones. The liquidity for these issues is almost nil due to a merger in subscribed package. There is no obligation to publish budget execution accounts of municipalities in the Official Gazette. Most times investors are seeking a reference for risk assessment. The municipal bonds risk sometimes is correlated to the insolvency risk of local employers and of local public companies.

Conclusions

The main premises of the municipal bond market development were the increasing financing needs of local authorities. But the financial crisis that had expensived and limited the access to bank credit, it gave additional support to develop this type of fixed income instruments. Commercial banks are not willing to provide financing as loans to local authorities, prompting the local public administrations to issue bonds. Local market bonds have a low liquidity because banks with the largest bond packages are controlling the market. The main effects of government funding by debenture loans should be weighed against the following approaches. On long term it generates an increase in tax pressure, influencing the behavior of financial market investors too. This leads to changes in interest rates on financial markets. Public resources borrowed fulfill a positive role if they are used for industrial development, agricultural modernization, construction of roads, environmental protection, increase the effectiveness of education and healthcare etc. If borrowed resources are not used for productive purposes, but for consume, loans bonds are not able to produce added value. Issuance of government bonds have strong implicats in the economy. They may influence financial markets by the amount of securities issued.

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